

Decision **PROPOSED DECISION OF ALJ BUSHEY** (Mailed 2/10/2006)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY (U 133-W), for an Order pursuant to Public Utilities Code Section 851 approving a Reallocation Agreement with the City of Folsom, as directed by D.04-04-069.

Application 04-07-018  
(Filed July 8, 2004)

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Attorney at Law, Keith Switzer, and Roland Tanner  
for Southern California Water Company, applicant.  
Morrison & Foerster, LLP, Derek F. Foran, for the City of  
Folsom, interested party.  
Cleveland W. Lee, Attorney at Law, and Sung B. Han,  
for the Office of Ratepayer Advocates.

**OPINION DETERMINING RATEMAKING TREATMENT FOR PROSPECTIVE  
REVENUES FROM SALE OF WATER RIGHTS AND DENYING APPROVAL  
PURSUANT TO SECTION 851<sup>1</sup>**

**Summary**

This opinion orders Southern California Water Company (SCWC) to record revenue received from the City of Folsom in a regulated account for the benefit of ratepayers, and to prudently provide such water resources as are necessary to serve its public utility customers. SCWC's request for approval of a

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<sup>1</sup> Unless indicated otherwise, all statutory citations are to the Public Utilities Code.

permanent lease pursuant to § 851 is denied; however, the City of Folsom's rights under § 851 are not changed.

**Background**

In Decision (D.) 04-03-069, the Commission found that SCWC violated Public Utilities Code Section 851 when it failed to seek the Commission's approval for its 1994 permanent lease of 5,000 acre feet per year (AFY) of water rights in the American River to the City of Folsom (Folsom). For that reason, the lease was voided; a penalty of \$1,095,000 was assessed, of which \$915,000 was suspended; and SCWC was ordered to credit ratepayers with 70% of the total lease revenues accrued from the inception of the lease through the effective date of the decision, plus 7% interest. The Commission also determined that while Folsom acted in "good faith for value," Folsom was entitled only to retrospective protection of its lease of water rights, pending further record development on the issue of Folsom's prospective rights under the voided lease. Folsom then filed a petition to modify D.04-03-039, indicating that serious and immediate effects had occurred because the Commission did not preserve its prospective rights under the lease. In D.04-04-069, after a review of new information provided by Folsom, the Commission concluded that § 851 protects Folsom's acquired interest in the water both with respect to the past and to the future, notwithstanding the voiding of the lease as to SCWC. This determination is not changed by today's decision.

The Commission also ordered SCWC to file an application to address the following topics:

1. How SCWC will obtain water sufficient to serve its customer base without the 5,000 acre-feet per year leased to Folsom?

2. What is the proper accounting and ratemaking treatment of future lease revenues under the Folsom lease?
3. What measures are appropriate to ensure ratepayers are not adversely affected by the lease of water rights to Folsom?

On July 8, 2004, SCWC filed this application to address these three issues, and obtain § 851 approval for the Folsom transaction. The Commission's Office of Ratepayer Advocates (ORA)<sup>2</sup> protested the application on July 8, 2004. A prehearing conference was held on October 14, 2004. The Assigned Commissioner issued a scoping memo, which adopted a procedural schedule calling for testimony and evidentiary hearings, and designated the assigned Administrative Law Judge as the principal hearing officer. The scoping memo stated that the Commission had already defined the scope of the proceeding in D.04-04-069 as being the three questions set out above.

Evidentiary hearings were held on June 14, 2005. SCWC presented two witnesses and ORA presented one for cross-examination. To accommodate the procedural schedule for SCWC's then-pending general rate case, briefing was delayed to October and November 2005. The proceeding was submitted for consideration by the Commission on November 23, 2005.

### **The Pollution Settlement Agreements**

In Application 03-10-057, SCWC sought Commission authorization to amortize over \$20 million in litigation costs related to groundwater pollution settlement agreements. We will not repeat here the complex transactions set

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<sup>2</sup> ORA subsequently changed its name to Division of Ratepayer Advocates. For clarity of the record, we will use ORA.

forth in the settlements agreements, but only summarize the pertinent points for today's decision.

The agreements require that the polluter, Aerojet General Corporation, provide replacement water for all polluted wells, first on an interim basis and then permanently. The interim supply is the five- year contract with the Sacramento Municipal Utility District for 10,000 acre-feet of surface water. The Coloma Treatment Plant will be expanded to accommodate this supply and pipeline extensions added to reach the areas previously served by the now-polluted wells. The permanent supply plan provides for Aerojet to discharge treated groundwater from an unspecified source into the American River where it will be diluted and delivered to the Coloma Treatment Plant or treated at a new treatment plant, then scheduled to be operational in December 2006. SCWC has admitted that construction of this plant is not on schedule.

The payment provisions of the settlement agreements are equally complex. Aerojet will reimburse SCWC approximately \$8,750,000 in capital costs for short-term measures necessary for replacement water. Aerojet will also pay \$8 million for additional capital costs. Both amounts are guaranteed. Aerojet made a further, but contingent, commitment to reimburse SCWC for over \$17 million in litigation expenses. The source of all payments is a \$6,000 per unit fee to be assessed on each housing unit developed on certain Aerojet real estate holdings near Sacramento. Aerojet has guaranteed the capital costs; that is, if the development fees are insufficient to fund the committed amounts, Aerojet will make up the difference. In contrast, the litigation reimbursement is contingent on the pace and extent of the development. Under the best case scenario,

unreimbursed litigation costs will be about \$7 million dollars, with the worst case being over \$30 million.<sup>3</sup> (See D.05-07-045, *mimeo.* at page 27.)

In D.05-07-045, the Commission granted SCWC's request for an immediate surcharge to begin recovering these costs. The adopted surcharge was a 19.15% increase in the general metered rate, and 14.89% on flat rate customers. The total annual amount collected from ratepayers is slightly over \$1 million.

### **Resolution of Issues**

SCWC and ORA presented evidence on each of the three issues, which we resolve below, followed by our determination of whether this transaction meets our standards for approval pursuant to § 851.

#### ***Issue 1: How SCWC will obtain water sufficient to serve its customer base without the 5,000 acre feet per year leased to Folsom?***

SCWC stated that it serves about 15,027 customers in the Arden-Cordova Service Area, which is comprised of the unconnected Arden and Cordova water systems. The Arden system cannot receive water from the American River system and is therefore not affected by the transfer to Folsom. The Cordova system currently has 13,240 customers, and SCWC predicts that full "build out" of the service area in 2022 will result in about 15,500 customers. SCWC forecasts that water demand will be about 22,200 acre-feet per year, with maximum daily demand about 25,325 gallons per minute.

SCWC states that it has sufficient ground water and surface water to meet this projected demand. SCWC explained that the Cordova system has 13 active wells with a total system design capacity approximately equal to 32,941 acre-feet,

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<sup>3</sup> Carrying costs also add substantially to the total.

more than enough to meet projected 2022 demand. SCWC admits, however, that groundwater contaminants threaten up to nine of its wells. SCWC further explained that remediation by the polluters, including providing replacement water, will ensure an adequate supply of water.

In addition to its groundwater, SCWC stated that it possesses rights to divert up to 5,000 acre-feet of water per year from the American River, and has entered into a five-year water transfer agreement with the Sacramento Municipal Utility District for 10,000 acre-feet of water. The agreement terminates in July 2007.

ORA countered that SCWC will be relying heavily on the risky strategy of purchases from third parties to meet the needs of its customers. ORA stated that that the 5,000 acre feet of water rights transferred to the Folsom are an important source of good quality water that SCWC controls from the source to the point of delivery. ORA concluded that the Folsom water rights, as compared to potential future purchases, are a superior source of water for SCWC's customers.

### **Discussion**

SCWC is relying on a factually and legally complex series of transactions to obviate the need for the water rights sold to the Folsom. ORA correctly observed that the water rights sold to Folsom were entirely under SCWC's control. The settlement agreements unquestionably add financial and resource complexity to SCWC's system as compared to unpolluted wells. Moreover, ratepayers are bearing about \$1 million in annual costs for these replacement resources.

Although SCWC has demonstrated that it currently has sufficient water supplies to meet the current needs of its customers, it is almost exclusively relying on a complex series of transaction to meet future need. ORA has raised

substantial questions about SCWC's ability to economically meet its customers' needs in the future, and SCWC has offered little to dispell this risk. We cannot definitively resolve SCWC's future resource needs. Customers are simply at risk that future supplies may be more costly, or, under the direst circumstances, not available at all. We address this risk below.

**Issue 2: What is the proper accounting and ratemaking treatment of future lease revenues under the Folsom lease?**

SCWC argues that no dollar value for the water rights was recorded in SCWC's rate base, and thus ratepayers have no claim to the water rights or proceeds from the sale thereof. SCWC provided accounting documentation showing that all costs of the acquisition were allocated among the other assets transferred and recorded in SCWC's rate base plant accounts. At no time were the water rights included in rate base. SCWC also cited to D.00-07-018 as supporting an allocation to shareholders of 70% of the proceeds.

ORA pointed to D.04-03-039 as dispelling SCWC's contention that the water rights were not included in rate base. ORA reads that decision as concluding that the cost of the acquisition, including the water rights, was included in rate base. Consequently, the ratepayers are entitled to all revenue from the sale. ORA recommended that all revenues for the lease of water rights to Folsom which were not addressed by D.04-03-039 be credited to regulated account No. 607, Sales to Government Agencies by Contracts.

SCWC opposed ORA's allocation of all revenues to ratepayers and contended that ORA provided no justification of such an allocation. SCWC stated that ORA did not draw any analogy to the Commission's precedent on gain on sale or allocation of revenues from excess capacity.

**Discussion**

In D.04-03-039, we thoroughly reviewed all aspects of the SCWC's 1964 acquisition of the Natomas Water Company and the subsequent lease to Folsom of 5,000 AFY. We addressed the ratemaking treatment of the proceeds retrospectively from the date of that decision. While today's decision addresses the prospective revenues, certain of the factual and legal determinations made in that decision continue to apply:

We now turn to the ratemaking issue. SCWC argues that the water rights were never in rate base, are non-utility/non-regulated property of SCWC and therefore the lease proceeds should accrue only to shareholders.

We do not accept that proposition. When SCWC purchased the Natomas Water Company in 1964, the transfer of water rights was included in the transaction. As even SCWC admits, certain amounts of those rights were exercised previously by the Natomas Water Company and subsequently by SCWC. The entire cost of the Natomas Water Company purchase, which included 32,000 AFY was borne by the ratepayers.

Shareholders were not separately responsible for recovery of any of the costs. We see no reason to assign the full benefit of the water rights to shareholders merely due to the fact that as SCWC states, "At that time - 1963 - it was common practice to attach no monetary value to water rights and therefore SCWC acquired these water rights for free."<sup>4</sup> The fact that the parties may not have assigned a particular line item value to the water rights does not mean those rights were free, especially since Natomas had obtained a benefit from the exercise of some of those water rights. Notwithstanding the lack of a separate itemization of the value of the acquired water rights, it is clear that the value of those property rights was included in the

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<sup>4</sup> SCWC Opening Brief, p. 19.

overall purchase price paid by SCWC. We determine that the entire amount of water rights was utility property at the time of the purchase. After the 1967 sale to Folsom, the entire remaining 10,000 AFY, which includes the 5,000 AFY being leased to Folsom, continued to be utility property.

SCWC has offered us no reason to alter our previous determination.<sup>5</sup> In additional support of this determination, we observe that SCWC's argument that the water rights were transferred without cost amounts to a contention that the sellers intended to make a gift<sup>6</sup> to shareholders, and the record contains no evidence supporting such intentions. We therefore conclude that the cost of acquiring the water rights was included in the sales price for the system assets purchased by SCWC, and that such costs were included in rate base.

In D.04-03-039, we divided the retrospective revenue from the lease between the ratepayers and shareholders, 70/30, respectively. To arrive at this sharing, we first noted that ratepayers had paid the costs associated with acquiring the water rights, and that shareholders had not borne any costs whatsoever. We then observed that the water rights would probably have been underutilized and that the shareholders should be rewarded for leasing this asset to a third party:

Based on the fact that ratepayers, not shareholders, have borne the cost of obtaining the water rights at issue as part of the purchase price of Natomas, it is reasonable to allocate most of the benefits of the lease to the ratepayers from the inception of

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<sup>5</sup> Pursuant to § 1709, all final orders of the Commission are conclusive in any collateral actions or proceedings.

<sup>6</sup> Black's Law Dictionary (1991) defines "gift" as: "a voluntary transfer of property to another made gratuitously and without consideration."

the lease. Further supporting the assignment of most of the lease revenues to ratepayers is the fact that the revenues are not the product of capital investment in plant or facilities by SCWC. This was an investment in preexisting water rights, funded by ratepayers. On the other hand, it is appropriate to assign shareholders a minority of the lease revenues in order to provide some reward for the leasing of an asset that probably would have been underutilized for most of the period from 1994 to the present had it not been leased. Based on these considerations and the unique facts of this case, we determine that 70% of the lease revenues should be assigned to ratepayers and 30% to shareholders. This apportionment should apply to any lease revenues accrued from the inception of the lease through the date of this decision.

We now consider the prospective revenues from the lease of the water rights to Folsom. The ratepayers continue to bear the costs of acquiring these water rights, and the shareholders have invested no capital. These facts have not changed.

We cannot, however, conclusively determine that the water rights will not be useful to SCWC at some point in the future. Consequently, we are in no position to find that shareholders merit a “reward” for this transaction.<sup>7</sup> As discussed in more detail below, we find that the transaction subjects SCWC’s customers to significant risk and that the terms of the lease do not meet our § 851 standards. We conclude that our sole justification in D.04-03-039 for allocating any portion of the revenue to shareholders is no longer applicable. SCWC has

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<sup>7</sup> This same analysis undermines SCWC’s contention that water rights are and will always be “surplus,” and pursuant to D.00-07-018 (the “excess capacity” decision) ratepayers would receive 30% of the revenue and shareholders 70%.

presented us with no other rationale to support a similar “reward” for the prospective revenue.

SCWC points to the Aerojet Settlement as providing a reliable source of replacement water, such that the 5,000 acre/feet sold to Folsom is no longer useful. Even if we were to accept SCWC’s contention that the settlement agreement replaces any need for the water rights sold to Folsom, ratepayers are bearing the costs of the Aerojet settlement and these costs should be offset by the Folsom revenue.

Therefore, all revenue from the lease of water rights to Folsom received by SCWC since the effective date of D.04-03-039 shall be recorded in Account No. 607, Sales to Government Agencies by Contracts, for the benefit of ratepayers. SCWC should file an advice letter specifying the necessary rate changes no later than 60 days after the effective date of this decision.

***Issue 3: What measures are appropriate to ensure ratepayers are not adversely affected by the lease of water rights to Folsom?***

ORA recommended that the Commission “order whatever measures will make the ratepayers whole,” and specifically suggested that SCWC replace the 5,000 AFY sold to Folsom with a like-kind water rights. SCWC offered no recommendations.

### **Discussion**

The record shows that ratepayers have not suffered any diminution in service or extra expense due to the sale of water rights to Folsom. In fact, ratepayers have benefited from their portion of the revenue being used to offset other expenses. The sale of water rights to Folsom, however, is permanent. Confronted with an uncertain future, we are unable to conclude that over the

term of the sale ratepayers will not at some point suffer some form of harm. Our challenge is to craft a means to mitigate the risk of unknown and unpredictable harm. This risk is also at the core of our analysis of whether this agreement should be approved pursuant to § 851.

As a certificated public utility, SCWC is obligated to “furnish and maintain such adequate, efficient, just, and reasonable service ... as are necessary to promote the safety, health, comfort, and convenience of its patrons.” § 451. Meeting this obligation requires that SCWC prudently acquire such water resources as are necessary to meet the needs of its customers. SCWC remains under this obligation notwithstanding the absence of the 5,000 AFY transferred to Folsom.

The risk that alternative resources may be more expensive or of lower quality is a risk that we cannot fully mitigate at this point. The best alternative is to give ratepayers the benefit of the transaction, i.e., the revenue, with the hope that these immediate benefits will offset any future burdens. In the context of SCWC’s obligation to provide efficient service, and given the unique facts of this case, we find that this resolution is reasonable and in the public interest.

ORA’s recommends that we order SCWC to acquire similar resources at shareholder expense, and to also allocate the full revenue from the permanent lease to ratepayers. We reject this recommendation because ratepayers are not entitled to have the 5,000 AFY and the revenue from the sale of the same resource.

**Should the permanent lease of 5,000 AFY be approved pursuant to § 851?**

Pursuant to § 851, no public utility shall “sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or part of any of its ... property necessary or useful in its performance of its duties to the public ... without

having secured from the Commission an order authorizing it to do so.” Every sale made without “an order of the Commission authorizing it is void.” The statute exempts good faith purchasers for value from its requirements.

In D.04-03-039, we determined that § 851 applied to the transaction with Folsom, and that SCWC had failed to file the required application. Consequently, we determined that the transaction was void, and fined SCWC for its failure to file the agreement. We subsequently modified that decision with D.04-04-069 to clarify that Folsom met the requirements for the exception to § 851, and that § 851 protects Folsom acquired interest in the water rights. Today’s decision denying § 851 approval has no impact on Folsom because its rights are not contingent on Commission approval. Folsom’s rights flow from the statute. Accordingly, today’s decision makes no changes to Folsom’s rights.

In D.04-03-039, we stated that § 851 review would have included assessing “whether the lease in perpetuity of the water rights could have an adverse impact on ratepayers by undermining SCWC’s ability to respond to water supply contingencies,” and potentially imposing conditions such as limiting the term or requiring termination rights for SCWC. See Conclusion of Law 21. In the subsequent decision, we also stated that § 851 requires that we determine whether the Folsom agreement serves the public interest, Conclusion of Law 4.

We are unable to make the findings required by § 851 for approval of the permanent lease of water rights to Folsom. SCWC bears the burden of proving that this transaction is in the public interest. ORA has raised significant questions about SCWC’s future ability to provide its customers with a water resource of similar quality and price. At a minimum, SCWC’s decision to transfer the water rights in perpetuity substantially limits SCWC’s flexibility to address future water supply contingencies. We, therefore, conclude that SCWC

has not shown that the permanent transfer of 5,000 AFY of water rights to Folsom is in the public interest, and we do not approve the transaction pursuant to § 851.

### **Comments on Proposed and Alternate Decisions**

The Proposed Decision of ALJ Maribeth Bushey and the Alternate Decision of President Peevey in this matter were mailed to the parties in accordance with Section 311(d) of the Public Utilities Code and Rule 77.1 of the Commission's Rules of Practice and Procedure. ORA filed comments supporting the Proposed Decision, and contending that the Alternate Decision was not supported by the record. ORA pointed out that SCWC had not shown that Aerojet's supply of groundwater was reliable or available. ORA provided record citations showing that ground had not yet been broken for the treatment plant that was scheduled to be operational in December 2006, and that SCWC did not know when it would be constructed. ORA concluded that the Aerojet supply did not mitigate the risk customers were exposed to when SCWC sold the water rights to Folsom.

SCWC did not file comments, but did file reply comments supporting the Alternate Decision, and contending that the Proposed Decision erred in its conclusion that SCWC had not proven that it could reliably and economically meet its customers' future needs. SCWC stated that the Aerojet settlement guaranteed an adequate supply to meet customer need at full build out of the area.

### **Assignment of Proceeding**

Michael R. Peevey is the Assigned Commissioner and Maribeth A. Bushey is the assigned ALJ.

**Findings of Fact**

1. SCWC has demonstrated that it currently has sufficient water resources to meet the needs of its customers, but has not shown that it will have sufficient resources for the term of the permanent lease of 5,000 AFY of American River water rights to Folsom.

2. The Aeroject settlement is factually and legally complex, and the treatment plant will not be operational as scheduled for December 2006.

3. Total litigation costs for the Aeroject settlement that are being assessed to ratepayers will be between \$7 and \$30 million.

4. The 5,000 AFY of American River water rights may be useful to SCWC at some time in the future.

**Conclusions of Law**

1. In D.04-03-039, the Commission held that:
  - a. the 5,000 AFY of water rights in the American River was utility property at the time of its transfer;
  - b. ratepayers incurred the cost of acquiring the 5,000 AFY of water rights in the American River;
  - c. shareholders invested no capital in acquiring the water rights transferred to Folsom; and
  - d. SCWC has a future need for the 5,000 AFY of American River water rights.
2. SCWC should not be rewarded for its permanent transfer to Folsom of 5,000 AFY of American River water rights.
3. The revenue from the permanent lease of 5,000 AFY of American River water rights to Folsom should be recorded in Account No. 607, Sales to Government Agencies by Contracts, for the benefit of ratepayers.
4. SCWC has not shown that the permanent lease of 5,000 AFY of American River water rights to Folsom is in the public interest.
5. SCWC's application to approve, pursuant to §851, the permanent lease of 5,000 AFY of American River water rights to Folsom should be denied.
6. SCWC must prudently acquire such water resources as are needed to meet the needs of its customers.
7. SCWC should file an advice letter implementing the Commission's final decision on this matter no later than 60 days after the effective date of that order.
8. This decision does not change Folsom's interest in the permanent lease of 5,000 AFY of American River water rights.
9. Today's decision should be effective immediately.

**O R D E R**

**IT IS ORDERED** that:

1. Southern California Water Company (SCWC) shall prudently acquire such resources as are necessary to meet the needs of its customers.
2. SCWC shall record the revenue from the permanent lease of 5,000 AFY of American River water rights to Folsom in Account No. 607, Sales to Government Agencies by Contracts, for the benefit of ratepayers.
3. SCWC should file an advice letter implementing the Commission's final decision on this matter no later than 60 days after the effective date of that order.
4. SCWC's application to approve, pursuant to § 851, the permanent lease of 5,000 AFY of American River water rights to Folsom is denied.
5. Application 04-07-018 is closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.